



LEGISLATIVE BUDGET ANALYSIS

2003 Biennium

Volume 1 – Statewide Perspectives

Presented to the Fifty-seventh Legislature

Submitted by

The Legislative Fiscal Division

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MONTANA LEGISLATIVE BRANCH

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December 2000

Members of the Fifty-seventh Legislature

I submit for your consideration a fiscal analysis of the state budget outlook for the 2003 biennium and Governor Racicot's Executive Budget. It is our goal that this analysis will provide the information and insight necessary for legislators to craft an effective state budget and fiscal policy for the 2003 biennium. This four-volume report includes:

- ?? Volume 1: Statewide Perspectives – This volume provides a summary overview of the state fiscal outlook and the executive budget analysis as well as a general reference section.
- ?? Volume 2: Revenue Estimates – This volume provides the revenue estimates and underlying economic assumptions included in the revenue estimate resolution (HJR 2), and is designed as a working document for the taxation committees.
- ?? Volumes 3 and 4 – These volumes are designed to serve as working documents for the appropriations subcommittees. They provide:
 - ✍ the Governor's agency budget recommendations, and
 - ✍ the Legislative Fiscal Division's detailed descriptions and analysis of the various components of the Executive Budget.

Your staff of the Legislative Fiscal Division look forward to being of service to the legislature during the 2001 session. We welcome any opportunity to assist you in obtaining the best possible fiscal information to facilitate setting fiscal policy. Staff names, assignments, and phone extensions are listed on page *xiii*. Please feel free to call on us!

I am deeply indebted to an exceptional staff LFD staff for their thousands of extra hours and personal sacrifice in preparing this analysis. Their dedication and professionalism are a credit to the Legislature and the citizens of Montana.

Respectfully submitted,

Clayton Schenck
Legislative Fiscal Analyst

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HOW TO USE THIS REPORT

The *Legislative Budget Analysis, 2003 Biennium* is published in four volumes. The report was designed to assist the 2001 Legislature in setting fiscal priorities and to help legislators reflect those priorities in the 2003 biennium General Appropriations Act (HB 2).

VOLUME 1

Volume 1, which includes a legislative summary, provides a “broad brush” overview of the proposed budget. *Volume 1* also summarizes significant fiscal issues that may impact more than one agency or that do not fall under the jurisdiction of a single appropriation subcommittee. Generally, this volume attempts to answer the following questions:

1. What is the current economic profile of Montana?
2. What is the state’s fiscal condition?
3. What are the major fiscal challenges facing the 2001 legislature?
4. What is the executive proposing for the 2003 biennium?
5. What are the significant issues identified by the LFD analysis?
6. What other fiscal issues are important to consider?

The “State Budget Outlook” section on pages 1 through 18 provides a high level summary of the material presented in *Legislative Budget Analysis*.

The reference section, at the end of *Volume 1*, presents a range of budget-related material. This section is considered especially useful by new legislators and those who have not previously had direct involvement in the appropriations process.

An index in the back of *Volume 1* is the most comprehensive for the purpose of searching for information in all four volumes.

VOLUME 2

Volume 2 includes a summary and overview of the state’s major revenue sources, including the general fund. This volume will be provided to the House and Senate Taxation committees for use as a working document, and

delineates the economic assumptions used to derive revenue estimates adopted by the interim Revenue and Taxation Committee and introduced in the revenue estimate bill (HJR 2).

VOLUMES 3 AND 4

Volumes 3 and 4 offer detailed analyses of individual agency budgets, as proposed through the Governor’s Executive Budget submitted in mid-November. These volumes feature program-by-program detail, as well as the LFD analysis of each agency budget. Agency presentations are grouped in sections corresponding to the appropriations subcommittee addressing the agency.

Volume 3:

- ?? A – General Government and Transportation
- ?? B – Health and Human Services

Volume 4:

- ?? C – Natural Resources and Commerce
- ?? D – Corrections and Public Safety
- ?? E – Education
- ?? F – Long-range Planning

A specific agency can be located in any of three ways. The general index included in each volume provides an alphabetical listing of agencies and other topics, in conjunction with appropriate volume and page numbers. If the subcommittee addressing a given agency is known, the cover page of each section lists agencies, in order by appearance. Agency names are also visible on page headings within sections.

Volumes 3 and 4 briefly describe the agencies from all three branches of state government, as well as each program within an agency. The basic structure used for the analysis is consistent across agencies. These volumes detail an agency’s requests, as well as a list of proposals and issues significant to the agency. When appropriate, there may be discussion of circumstances that could hold budgetary impacts (e.g., proposed executive legislation or agency reorganization). These volumes also present detailed discussions of present law adjustments, new proposals, and significant issues facing the various agencies as identified by legislative fiscal analysts.

Agency budgets are presented in three tiers as required by statute:

1. **Base budget:** the level of funding authorized by the previous legislation;
2. **Present law base:** the additional level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature; and
3. **New proposals:** requests to provide new non-mandated services, to change program services, to eliminate existing services, or to change sources of funding.

By making this presentation in this tiered manner, legislators can use the “base budget” as the starting point, then to follow the incremental increases that result in a total budget request for an agency.

Proprietary Rate Setting

HB 576 (1995) removed the requirement that proprietary – or internal service and enterprise – funds be appropriated by the legislature. Instead, the legislature approves the rates charged for those particular services and products. HB 576 also requires the Office of Budget and Program Planning to submit a report as part of the Executive Budget. This report includes fees and charges, projected fund balances, retained earnings, and contributed capital for providers. Although the legislature does not appropriate funds for the operation of these programs, it does approve the rates charged. These reports and the LFD analysis of the reports are included in the agency presentations in volumes 3 and 4, as appropriate.

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What is the current economic profile of Montana?



STATE PROFILE

MONTANA ECONOMIC OUTLOOK

Montana state government like any other business, is influenced by economic and demographic developments. For example, Montana's economic base as well as the strength of the U.S. economy determines the level of revenues collected from personal and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic variables affect state government disbursements for education, human services, corrections, and other governmental services.

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since income tax revenue is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Federal revenue correspondingly is used to fund a number of human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

Montana's total expenditure base is targeted toward educational and human service programs, with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, an increase in population or a reduction in unemployment levels is usually the result. Along with population, increases come corresponding increases in educational and human service costs. A larger population requires a better transportation system not only for the general populace, but also for the businesses that expect to expand to meet the needs of an ever-growing population.

The 1990's were generally good years for Montana's economy. With a few exceptions, Montana experienced above average employment and wage levels that translated into strong tax revenue growth. This revenue growth was further enhanced by the significant increase in the equity markets and the resulting growth in capital gains income. The future, however, does not look as promising as the effects of a national economic slowdown begin to take place as reflected by the bearish mood on Wall Street.

For several months, the Federal Reserve has incrementally increased interest rates to ensure that the national economy does not expand too quickly and to hold inflation in check. Many economists are now suggesting that the Federal Reserve may have over-corrected by raising interest rates too high. Many of the earnings reports issued by major U.S. companies are showing slower growth and reduced revenues as the result of a sluggish economy.

These trends indicate a similar slow-down for Montana's economy. Montana's economy is highly dependent on agriculture, tourism, natural resource extraction, and mining. All of these industries perpetuate residual wholesale/retail trade and service sector jobs. If the basic industries are not flourishing, other sectors suffer as well. And if Montana's economy slows, tax revenue growth usually follows the trend because of the state's dependence on income tax revenues.

The irony of an economic slowdown is the inverse effect it may have on state expenditures. During a period when revenue growth is slowing, governmental service demands may actually increase at a faster rate. For example, if unemployment increases, this may translate into a greater demand for human service benefits and a greater need for correctional facilities and services.

The revenue estimates as adopted by the Revenue and Taxation Committee (RATC) are based on a slowing economy at both the national and state levels. This general premise is supported by testimony the committee received prior to the adoption of the final revenue estimate recommendations. The RATC heard from Michael Donnelly, Wharton Econometrics Forecasting Associates; Dr. Paul Polzin, Bureau of Business and Economic Research; Dr. Myles Watts, Department of Agricultural Economics, Montana State University; and Dr. Phil Brooks, Department of Labor and Industry. Each of these economic experts provided the committee with his outlook on various aspects of the state and national economies.

A major emerging factor that the RATC did not consider is the effect energy prices are having on businesses in this state. While natural gas and oil prices are at historic highs, electricity prices have increased so significantly that several state businesses have either reduced their labor

force or have shut down operations altogether. Some of the businesses affected include Montana Resources, Jore, Columbia Falls Aluminum, and Pyramid Lumber. State revenues could be severely affected if these layoffs continue indefinitely and the state and national economies continue to slow.

The economic outlook for the state is very tenuous at this time. Employment and wage indicators continue to support slow to moderate growth. Some of the effects of higher interest rates and energy prices are beginning to show, but may not be fully realized until after adjournment of the legislative session. If equity markets continue to fluctuate like they have during the past year, state revenues could be impacted significantly.

What is the state's fiscal condition?



STATE FISCAL PICTURE

INTRODUCTION

The previous section described the economic outlook for Montana from the perspective of how economic activity at both the state and national level impacts state revenues and expenditures. This section describes in more detail

how those economic conditions determine the state fiscal outlook and ultimately the size of the 2003 biennium budget.

GENERAL FUND REVENUE IMPLICATIONS

Montana's fiscal outlook for revenue growth is less optimistic than in previous biennia. The key economic assumptions targeted as most affecting state government receipts are Montana total income and employment levels, inflation rates, corporate profits, and property values. These assumptions are crucial because almost 80 percent of general fund revenues come from income tax, property tax, and investment earnings.

Individual income tax. The rate of growth in individual income tax revenues is expected to slow in fiscal 2001 when compared to fiscal 1999 and 2000, and increase about 5 percent in fiscal 2002 and 2003. Wage and salary income grew by only 4.3 percent in calendar 1999, compared with the rapid growth of 5.7 percent in calendar 1998. Growth in wage and salary income in calendar 2000 is expected to be 5.6 percent due to increased employment in construction, services, and trade. However, growth in wage and salary income is expected to slow in calendar 2001 through 2003 to slightly above 4.5 percent per year, as a slowdown in corporate and business profits causes a reduction in hiring.

Growth in capital gain income is also likely to moderate during the 2003 biennium. The rising stock market in the latter half of the 1990's provided a boost to state and national income tax revenues derived from capital gains. The stock market in calendar 2000 has been extremely volatile and is lower now than it was in January. The outlook by many national forecasting firms for growth in the S&P 500 index in the next two years is for a slowly

increasing market, with high volatility, where losses and gains are equally probable.

Corporation income tax. Corporate profits are expected to range from stable to a moderate increase as the effect of an economic slowdown begins to take place. Business and corporate executives will be under pressure to maintain net incomes. This will result in slower business expansion, which should result in reduced hiring.

Corporate revenues during the 2001 biennium had large one-time increases from the sale of Montana Power Company's electrical generation assets and other significant one-time transactions. Currently, all but the telecommunications assets of the Montana Power Company have been offered for sale with buyers announced. These sales may produce another windfall in corporate taxes in the future, but the uncertainty regarding their level and timing is unknown.

Property tax. Property tax revenues from real estate will be down during the 2003 biennium, after remaining flat during the 2001 biennium. Most of this decline is the result of property tax cuts enacted by the Fifty-sixth Legislature. The tax rate cuts included moderate reductions for residential and commercial real estate, agricultural land, and timberland, which offset the phase-in of the 1997 reappraisal values. In addition, large tax rate cuts were enacted for business equipment, electrical generation, and telecommunications property. To partially offset these property tax revenue declines, the Fifty-sixth

Legislature increased tax rates on wholesale sales of electrical energy and retail sales of telecommunications services. Income from the latter is not being realized at the expected amount.

Tax rate cuts for light vehicles were also enacted by the Fifty-sixth Legislature. Tax rates on light vehicles were reduced by 30 percent, and the legislature reallocated the remaining revenue almost entirely to local governments and schools. In November 2000, the populace approved an initiative to change the levy on light vehicles from a tax

to a registration fee. This initiative further reduced the revenue from the taxation of vehicles.

Investment earnings. Investment earnings will be down slightly because cash balances available for investment will be stable to declining. Interest rates have probably peaked, with a high probability of declining rates in the future. This is because the Federal Reserve may have increased rates in an attempt to ensure that the national economy did not expand too quickly. The Federal Reserve may now begin to adjust them downward.

GENERAL FUND EXPENDITURE IMPLICATIONS

Montana's expenditure growth like revenue growth, is responsive to economic and demographic conditions. While income levels, commodity prices, and interest rates significantly influence revenue trends, expenditure trends are more susceptible to inflationary pressures, population trends, and demographic characteristics.

GENERAL INFLATION IMPACTS

Inflation rates, as projected by Wharton Econometrics Forecasting Associates (WEFA), are expected to remain relatively stable during the 2003 biennium at 2.4 to 2.6 percent per year. Inflationary increases have an impact on governmental operations in a number of ways as highlighted below:

1. As happens to every consumer, the price the government pays for goods and services increase because of price adjustments. Although state government does not purchase the same mix of goods that consumers do, the price of the goods they do purchase will increase in response to adjustments for inflation. Correctional services are a good example of a state operation that experiences high inflationary impacts relative to food and medical service purchases.
2. Secondly, over 20 percent of general fund expenditures are for labor costs. Historically, the legislature has attempted to adjust employee compensation upward by an amount that recognizes the effects inflation has on an employee's take-home pay. The Executive Budget proposes to increase

employee pay by 4 percent each year of the biennium to compensate for these inflationary impacts.

3. Finally, over 60 percent of general fund expenditures are for educational support costs and direct human service benefits. For both types of these services, inflationary increases can be substantial. Educational costs are directly tied to an increase in employee compensation, while human service benefits are heavily influenced by the cost of medical services.

POPULATION AND DEMOGRAPHIC IMPACTS

Montana's population in 1990 was 799,065 and increased to 882,779 by 1999. This is an overall increase of 10.4 percent or an annual average growth of 1.1 percent per year. Total population growth trends in recent years have abated from this historical level and are expected to grow at only 0.8 percent per year throughout the next biennium. Even with a slower growth rate, the state population should exceed 900,000 during the 2003 biennium.

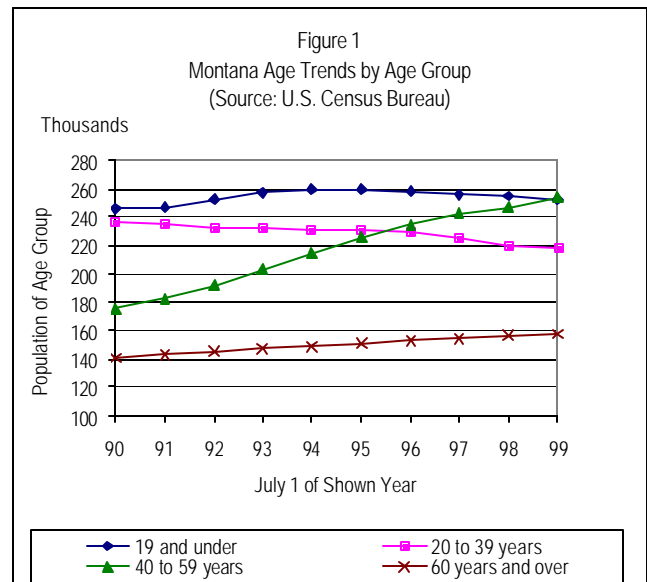
Even with slower growth in total population, the demand for state services continues to increase. Depending on the demographics (age, income, etc.) of the population base, the demand for government services will emerge in the form of increased school enrollments, caseloads, or government employees' workload. Demographics play a significant role in determining the cost of governmental services.

Figure 1 is a representation of the changes in Montana population by major age groups. The chart shows that the age group that includes school age children peaked in the mid-1990's and has decreased slightly since then. In the last few years, this trend has been reflected in the cost for public school support.

At the other end of the spectrum is the "60 years and over" cohort which shows a steady gain of 12.0 percent over the 10 year period. This is not very different from the total population increase (10.4 percent) for the same period.

The most significant trend shown in Figure 1 is the growth rate (44.9 percent) observed in the "40 to 59" age group. This group includes the much-discussed "baby-boomers" and is the largest age group displayed. Over the next 20 years, these individuals may place increased pressure on federal and state social programs and consequently on younger generations. It is also important to consider the impact this demographic change may have on Montana's workforce and upon the availability of the workers businesses will need to fill jobs.

Finally, Montana is a large state with a sparse population. One implication of this characteristic relates to how its citizens access government. Some state programs, because of the nature of their services, must maintain a



presence in numerous communities in order to ensure adequate access. Others have used information technology to provide citizens with access to services. Providing adequate access to government will require more local services or the expansion of information technology capabilities, both of which are costly.

SUMMARY

In summary, revenue growth is expected to be slow to moderate during the 2003 biennium. This rate of growth is not expected to be nearly as strong as observed during the late 1990's. This premise is based on slower growth in income tax revenues with a property tax base that is increasing but still below the fiscal 2000 level. Investment earnings are expected to decline.

The cost of governmental services will continue to increase even with a moderate rate of inflation and a slow growth rate in total population. Since employee compensation has not kept pace with inflation, there will be continued pressure to increase employee pay. Conversely, school enrollments are declining, yet costs to support public schools continue to increase. This is

because of the efforts of past legislatures to increase state support for schools and provide relief to local taxpayers. Human services costs will continue to escalate because of greater caseload demands and higher medical costs.

Overall, the budget picture is in a satisfactory state when viewed from a perspective of funding existing services. This means that there are sufficient revenues to fund present law services and still leave an adequate ending fund balance, or reserve. The legislature however, will be faced with significant challenges to balance the budget without creating structural imbalance as it attempts to address the issues of economic development, educational funding, tax reform, and rising human services costs.

What are the major fiscal challenges facing the 2001 legislature?



MAJOR FISCAL CHALLENGES

The 2001 legislature faces a budget outlook that is not as positive as it has been in recent biennia. The 2003 biennium budget has sufficient present law revenues to adequately support present law expenditures, but it lacks the necessary funding for other considerations such as the pay plan and a long list of Executive Budget new proposals. The prospect of reductions to the present law base in order to fund new proposals is very possible if tax increases are not considered an option. The expectation of slower growth in the economy adds further reservation to the view that the 2003 biennium budget outlook is positive.

The incoming legislature faces many challenges. Following is a summary of key challenges and uncertainties that must be considered in formulating the 2003 biennium spending plan and addressing related fiscal issues.

?? **Economic uncertainties** will make budget planning and development difficult. Nagging concerns about the national/world economy, and federal budget reforms leave policymakers uneasy about revenue estimates, program funding levels, and increases in demand for governmental services.

?? **Utility costs** have increased so significantly that several large state businesses have either reduced their labor force or have shut down operations. The legislature may wish to consider how the state could respond to this in light of a goal to retain jobs or further economic development.

?? **Adequacy of the ending fund balance** reserve for the general fund requires an evaluation by the legislature, particularly in view of economic uncertainties and the potential for future spending in the form of supplemental budget

requests. The legislature needs to ensure that an adequate "safety net" is in place.

?? **Controlled budget growth** (structural balance) will continue to be a concern as the 2003 biennium unfolds. Governor Racicot's present law budget request shows a 6.9 percent increase in general fund obligations. When new proposals are figured in, the requested general fund increase is 10.2 percent. The legislature will need to give careful consideration to any budgetary actions in order to avoid over-committing available resources. This is particularly true in light of the fact that ongoing revenues are projected to be substantially lower than the proposed expenditure growth.

?? **Tax Reform** proposals are common during any legislative session. In a tight budget session, such proposals add to the uncertainty surrounding the budget. One major tax reform bill comes from the interim Revenue and Taxation Committee, which formed a subcommittee to investigate ways in which the current income tax system might be modified in order to remove the perception that Montana has one of the highest marginal tax rates. The proposal would reduce the number of income tax brackets to four and the highest marginal tax rate would be 6.6 percent. The proposal would eliminate the deductibility of federal taxes paid.

?? **Correctional system population** continues to grow. Underestimating the growth could result in a budget-breaking supplemental request, and overestimating could skew the prioritization process, taking funding away from other program areas.

?? **Local government funding** has experienced uncertainty resulting from property tax

reductions. While most of these reductions have been reimbursed by the state, continued reimbursement will be a priority for local governments. The 1999 legislature recognized this problem and authorized an interim Local Government Funding and Structure Committee, which will propose legislation to eliminate local government reimbursements and create permanent local government entitlements.

?? **Funding for schools** is an ongoing concern. In recent years, public schools have been faced with declining K-12 enrollments and declining budget authority without equal reductions in costs. Governor Racicot and Governor-Elect Martz have both indicated that public school funding is a top priority.

?? **Economic development** will be a high priority for the new administration as the state attempts to address its economic climate and why Montana continues to rank close to the bottom in per capita income.

?? **Higher federal-aid highway construction funds** will continue to be received to support highways infrastructure. Providing state match funds at this higher level, where annual expenditures exceed revenues, will be difficult over the long term. The Fifty-seventh Legislature may want to address this issue and develop a long-term solution to the structural balance of this account.

?? **Health care cost inflation** continues to be a major contributor to greater than average growth in health and human services budgets such as

Medicaid, state employee health insurance plans, institutions, and university system units. This could drain the general fund budget, as it did in the early 1990s, Medicaid costs show signs of acceleration.

?? **Supplemental emergency appropriations** for the next biennium are not budgeted for by the legislature and not accounted for in the ending fund balance. Yet the state experiences some supplemental appropriations each biennium, particularly for fire suppression. The legislature will need to consider future supplemental appropriations when determining an appropriate ending fund balance.

?? **Pending litigation** with potential impacts include: 1) the Crow Tribe Reserved Water Rights Compact and Coal Severance Tax Settlement, which was ratified by the legislature in the 1999 Special Session, is still being discussed by the state and the tribe; and 2) a challenge against the constitutionality of the 1.5-mill levy for the support of the state's vocational-technical education program.

?? **Higher education** has been funded to a greater and greater degree in recent biennia with increased tuition charges, as general fund becomes a smaller share of total funding. The legislature will need to consider issues relative to appropriate funding levels for higher education.

What is the executive proposing for the 2003 biennium?



EXECUTIVE BUDGET HIGHLIGHTS

INTRODUCTION

As outlined in the preceding sections, a relatively tight state budget picture faces the Fifty seventh Legislature, as slow to moderate revenue growth leaves only enough to continue present law services. This section highlights Governor Racicot's response to the state fiscal outlook and priorities the Governor applied in building the state budget for the 2003 biennium.

The Governor proposes a balanced general fund 2003 biennium budget with a \$43.7 million ending fund balance. It provides for a 10.2 percent increase in general fund

expenditures and a 16.3 percent increase in all funds. It is funded with increased current revenues and new revenue from an increase in cigarette and tobacco taxes.

Governor Racicot's revenue proposals are discussed in more detail in the "Executive Revenue and Tax Policy Proposals" section on page 37. His expenditure proposals are summarized in the "Executive Expenditure Proposals" section on page 43. The following summarizes the key features of the executive budget within the major categories of revenues and expenditures.

HIGHLIGHTS OF REVENUE PROPOSALS

The Executive Budget is based on estimated revenues in excess of those adopted by the Revenue and Taxation Committee on November 17, 2000. The executive included \$25 million more than the Revenue and Taxation Committee for telecommunications excise tax revenues and a difference in all other categories of a negative \$1.8

million. This places the executive general fund revenue estimates \$23.2 million below the \$3.586 billion adopted by the committee for a three year period. For a complete discussion of revenue estimates, see "General Fund Revenue Estimates" on page 22 of this report and [Volume 2 – Revenue Estimates](#) of the LFD Budget Analysis.

TAX REFORM PROPOSALS

The Executive has proposed four initiatives that will alter taxation rates or otherwise impact the revenue in the general fund and other state funds. They are:

Cigarette and Tobacco Tax Increase. The executive proposes to increase the state tax on cigarettes from 18 to 56 cents per pack, and increase the tax on tobacco from 12.5 percent to 45 percent of retail value. The distribution of cigarette tax revenue is also changed and the revenue increase to the general fund is \$47 million during the 2003 biennium.

Cultural Heritage Loans. This proposal provides heritage tourism loans from a trust controlled by the Board of Investments for construction and maintenance of sites of historical significance. The debt service on the loans is financed by an increase in the lodging facility use tax from 4 percent to 5 percent. The cost to the general fund for the 203 biennium is \$2.7 million.

Eliminate the Termination Provision for the Qualified Endowment Credit. The executive proposes to make the qualified endowment credit against income and corporate tax liability permanent by eliminating the current sunset date of December 31, 2001. The amount of the credit would also be reduced from 50 percent of the qualified gift

amount to 25 percent. The revenue loss to the general fund is expected to be \$5.2 million in fiscal 2003.

Micro-Business Loans. The executive proposes to appropriate \$2.5 million from the coal tax permanent trust

to the Department of Commerce for additional loan authority for the micro-business finance program. The cost to the general fund for the 2003 biennium is \$0.4 million.

HIGHLIGHTS OF EXPENDITURE PROPOSALS

The executive is recommending a 2003 biennium budget that includes an additional \$234.0 million from the general fund, a 10.2 percent increase. Total requested increases amount to \$891.2 million, a 16.3 percent spending increase. The executive proposal for general fund and total spending increases is supported by existing sources of revenue, in combination with revenues from proposed tax increases on cigarettes and tobacco products. The increased spending includes significant new proposals/initiatives that account for nearly \$365 million of the budget for the 2003 biennium. Federal funds provide for over 70 percent of the total funds increase. Over 51 percent of the general fund budget goes to education (K-12 and higher education), 21 percent to human services, and nearly 9 percent to corrections.

The highlights of the proposed budget are:

Human Services. Human services costs would increase \$410.5 million, or 25.6 percent (including almost \$150 million in accounting changes). General fund would increase \$70.6 million, or 15.3 percent. Major general fund increases are for increased Medicaid costs and the annualization of provider rate increases, a new provider rate increase, increased child protective services staffing and services, and enhancements to and/or annualization of cost increases in several other programs, including mental health, disabilities services, and the Children's Health Insurance Program.

Education. K-12 education general fund costs would increase \$18.7 million, or 1.9 percent, and \$50.8 million in total funds, or 4.5 percent. Declining enrollments cause BASE aid expenditures to decline by \$2.8 million. The executive proposes a special education adjustment and increases the BASE aid schedules by 3 percent in fiscal 2003 at a cost of \$14.4 million.

Higher Education. The executive would increase general fund for higher education by \$28.4 million (11.3 percent), and total funds by \$31.1 million (10.9 percent). The general fund includes replacement of revenue lost by a 6 mill-levy reduction amounting to \$5.8 million and an accounting change to total funds, which adds \$14.5 million in federal funds. Neither of these adjustments adds funding. Enrollment growth is expected to be low in the 2003 biennium. The executive proposes enhanced student assistance, replacement of the 6 mill-levy revenue reduction, and increased state funding equivalent to \$100 per student in fiscal 2002 and an additional \$100 per student in fiscal 2003.

Corrections. Governor Racicot proposes adding general fund of \$31.6 million, or 17.6 percent. Increases of \$19.9 million are provided for increasing populations. Costs relative to additional staff and pay exceptions add \$9.4 million.

Long-Range Building Program (LRBP). The LRBP request is for \$163.7 million total funds. Of this amount, \$81.3 million is for bonded projects, which include: \$40.7 million for construction of a new building for the Department of Public Health and Human Services, and \$82.4 million for the cash projects, including \$4.3 million from the Long-Range Building Program Account. The Executive Budget also includes a proposal for \$3.0 million in additional spending on cash projects, provided that an increase to the cigarette tax is approved.

Local Government Reimbursements. The Governor provides full funding for local government reimbursements as a result of the passage of SB 184 by the 1999 legislature. Appropriations in the 2001 biennium were \$70.6 million. The Governor proposes \$109.9 million general fund in the 2003 biennium, or an additional \$39.3 million.

Executive Pay Plan. The executive is proposing a \$72.0 million (\$30.1 million general fund) pay plan for state employees in the 2003 biennium.

FTE Increase. The number of state employees would increase by 541 FTE, or over 5 percent, primarily in corrections, human services, and transportation.

Governor's Economic Development Program. The economic development plan in the Executive Budget is,

for the most part, a continuation of initiatives approved by the legislature in the May 2000 Special Session.

Federal Funds. Federal funds increase by \$576.1 million, or 27.6 percent, primarily in human services, low-income housing, and highways construction and maintenance. Federal funds also include over \$160 million in accounting changes recommended by the Legislative Audit Division.

OTHER FEATURES OF THE EXECUTIVE BUDGET

Supplemental Appropriations – Fiscal 2001. The executive's preliminary supplemental recommendation totals \$66.6 million, of which \$38.8 million is general fund.

Vacancy Savings. The executive applies a 3 percent vacancy savings rate to all personal services except insurance contributions. Vacancy savings reductions total \$28.6 million over the 2003 biennium, of which about \$12.0 million is from the general fund.

Fixed Costs. In each agency budget, fixed costs refers to costs for services from several programs within state government that provide services to other functions of

state government, for which they charge a fee. Fixed costs increase by over \$17 million in the 2003 biennium.

Inflation/Deflation. Inflation is applied to only selected expenditure categories. Underestimating others does not maintain the same level of buying power for state agencies as fiscal 2000 and, therefore, statutory present law is not maintained.

Other Fund Issues. Under the Executive Budget, expenditures for the highway special revenue account will exceed revenues and some accounts that receive revenue distributions from the resource indemnity account will be over appropriated.

What are the significant issues
Identified by the LFD analysis?



LFD BUDGET ISSUES

INTRODUCTION

The preceding chapters discussed the state economic outlook, the state budget fiscal picture, and the major fiscal challenges faced by the 57th legislature within the context of the economic and state budget outlook. Also presented were highlights of the Racicot Administration budget proposal. The following is a discussion of the significant issues identified by the LFD during its in-depth analysis of the Racicot budget and the implications of the proposal as a response to the current economic and fiscal

outlook. The purpose of this section is to alert the legislature to the fiscal issues they will encounter, and not to evaluate the merits of the policy issues proposed by the executive. While the issues raised here are not exclusively related to the Racicot budget, other fiscal issues are primarily addressed in the next section of this report. For a detailed analysis of each agency's budget, refer to Volumes 3 and 4.

OVER-ARCHING ISSUES

Because economic uncertainty or slowdown can lead to a growth in demand for governmental services and cause a reduction in revenues, it requires a judicious examination of current and projected costs, as well as heightened awareness of the importance of structural balance.

The following highlights three primary issues about Governor Racicot's proposed budget:

1. Government increases in size across a broad spectrum of services. The increases are primarily in education, corrections, and health services, which consume over 90 percent of the general fund HB 2 budget. General fund increases by over 10 percent. This increase funds on-going programs, including over 540 new FTE.
2. Costs of several new initiatives proposed by the Governor are phased-in over the next two biennia, meaning on-going costs in the 2005

biennium will exceed the proposed expenditures in the 2003 biennium. Among the phased-in initiatives are the state employee pay plan, provider rate increases, debt service, and increases in state support for both K-12 and higher education enrollments.

3. Proposed expenditures are growing faster than anticipated revenues, and this budget relies on one-time revenues and a tax increase to fund on-going expenditures.

Given the signs of economic slowdown, the primary issue for legislative consideration is: *Can this budget level be sustained in future biennia?*

SPECIFIC ISSUES

In terms of the fiscal challenges identified earlier, and within the context of the above overview, the following discussion looks at the various components of the Executive Budget and potential issues they and other non-executive proposals may raise. Since the general fund is the main focus of the state operating budget, the discussion below relates to general fund issues unless otherwise stated.

?? **Economic uncertainty** was addressed earlier as a major challenge of the 2001 session, especially as it relates to controlling budget growth so that the budget can be sustained in a slower economy. The double-digit growth of the Racicot budget does not fit well in an environment of revenue uncertainties and the state economy.

?? **Adequacy of ending fund balance** is in question. The Racicot budget is balanced and leaves a proposed ending fund balance of \$43.6 million at the end of the 2003 biennium. This represents only 1.7 percent of the proposed biennium budget of \$2.5 billion. Experts recommend and most states maintain an ending fund reserve of at least 2.5 percent, which would amount to \$60 million. This is particularly critical in the current climate of economic uncertainty, and also since Montana does not have a "rainy day" fund as the majority of other states do in addition to an adequate reserve. It should be noted that the supplemental requests and the emergency appropriations at the level of that requested by the Racicot budget for fiscal 2001 would deplete the recommended \$43.6 million balance in its entirety. (Page 93).

?? **Controlled budget growth** will be a concern in a period of economic uncertainty, and as previously discussed, the Racicot budget shows a biennial 6.9 percent increase in general fund for present law funding. When new proposals are included, the requested general fund increase is 10.2 percent. There is significant growth in all major expenditure areas of the Executive Budget, including K-12 education

(\$18.7 million), higher education (\$28.4 million), health and human services (\$70.6 million), and corrections (\$31.6 million). In addition, the budget calls for a substantial increase in local government reimbursement (\$39.3 million), and a statewide growth of 541 FTE. Not all of these FTE would be supported by the general fund. These will cost more in future biennia, likely exceeding the rate of growth of revenues, creating an issue of structural balance, which is discussed further below.

?? **Structural Balance** refers to the matching of ongoing expenditures of government with ongoing revenues. For the 2003 biennium, the proposed Executive Budget would result in a structural imbalance. The imbalance could be as high as \$100 million. The budget is balanced with a tax increase, use of one-time revenues, and use of ending fund balance, resulting in the structural imbalance.

For the longer term, lack of structural balance is a more ominous threat since there are significant new initiatives with a delayed start in the 2003 biennium that would require full funding in the 2005 biennium and beyond. While a delayed start means lower costs in the budgeted biennium, it compounds cost expansion in future biennia, and leads to long-term structural imbalance. The state employee pay plan, the fiscal 2003 K-12 BASE aid increases, and provider rate increases are examples of delayed implementation proposals that will contribute to structural imbalance in future biennia. The pay plan, for example, will cost \$20 million more in the 2005 biennium than it will cost in the 2003 biennium.

The structural imbalance in the budget proposal leaves future legislatures faced with the task of rebalancing the ongoing expenditures with ongoing revenues, particularly in a period of slower economic growth. (Page 75)

?? **Tax Policy** measures are not a significant part of the Racicot budget plan. The only major tax issue included in the balanced budget proposal is for the cigarette and tobacco tax increase to

generate over \$47 million in general fund revenues in order to balance the budget. Three relatively minor revenue and tax measures are included in the proposal. Another proposal, for implementation of a tourism sales tax, is offered by the executive but is not part of the balanced budget submission. (Page 37)

?? **Corrections system population** continues to grow, and the Racicot proposal requests an 18 percent general fund increase. This is the third consecutive biennium of double-digit growth in this area. While prior biennia focused on infrastructure to provide enough beds, the issue in this budget is primarily funding for costs of a growing prison population. The LFD analysis cites many areas where the present law request appears to be in excess of what is needed to continue present service levels. In addition, the cost increase exceeds the rate of projected growth in population.

?? **Local government reimbursement** for lost revenue due to tax policy changes would grow by nearly \$40 million in the Racicot proposal, which provides for full reimbursement (as directed in statute). Again, the issue of sustainability of budget growth of this level in future biennia needs to be carefully considered during the 2001 session. The 1999 legislature authorized an interim local government funding and structure committee, which will propose legislation to eliminate local government reimbursements and create permanent local government entitlements.

?? **Funding for schools** is an ongoing concern, and is addressed in the Racicot proposal with a 3 percent BASE aid increase in fiscal 2003. The delayed implementation of this proposal for the current biennium holds the cost of the increase to \$19 million, (when combined with enrollment declines), but the cost in the next biennium to fund the increase for two years will be double.

?? **Economic development** has been a major priority of the Racicot administration, and is Governor-elect Martz's stated number one priority. The Racicot budget continues the \$16

million biennial package approved in the May 2000 special session.

?? **Federal-aid highway construction funds** would grow. The executive budget includes increased state funding from the highways special revenue account to provide sufficient match for an expanded federal aid construction program. The level of funding leaves the highway fund at a precariously low level at the end of the 2003 biennium, a result of a chronic imbalance, where expenditures always exceed annual revenues. There may be insufficient funds or cash flow in the 2003 biennium to take full advantage of federal match funds. The budget proposal does not address the longer term shortfall in the fund, which will require action by the next legislature if not addressed in this session. (Page 100)

?? **Health care cost** growth of over 15 percent is reflected in the Racicot proposal, as a result of increased caseload, expanded services, and health cost inflation acceleration (reminiscent of the 1980's and early 1990's). Cost containment is addressed to some degree in the proposal for mental health services, but is not a significant part of the overall health care budget proposal. The potential for cost acceleration for health services will demand close attention by lawmakers.

?? **Energy costs** have increased significantly, and the increase provided in the Racicot budget in the form of inflation factors is significantly less than estimates for energy cost increases into the next biennium. Agencies with significant energy use may face significant funding shortfalls if energy costs increase as predicted.

?? **Supplemental appropriations** in the Racicot budget for fiscal 2001 are nearly \$40 million, and may increase. While the high number is due in part to a severe fire season, supplementals have averaged almost \$30 million per biennium (since the 1987 biennium), and have never been included in ending fund balance projections for the next biennium. With a \$43 million projected ending fund balance in the Racicot budget,

supplementals alone could nearly deplete a safety net of that level. The legislature should take in to consideration potential supplemental appropriations when determining an appropriate ending fund balance.

?? **Higher education** receives an 11 percent increase, which includes an adjustment for the 6-mill levy revenues lost due to the impacts of tax relief. Again, the increase is partially delayed until the second year of the biennium, resulting in higher costs to sustain that level in the next biennium. While this is a substantial increase, there is still the larger debate as to what the total state funded share of higher education should be.

What other fiscal issues
are important to consider?



OTHER FISCAL ISSUES

The Legislative Fiscal Division analysis also includes several fiscal issues not directly related to the Executive Budget, but that will potentially have an impact on the budget passed by the legislature and/or the budget process. These fiscal issues are varied and sometimes complex. It is important that the legislature be aware of them in its deliberations. The following briefly describes each issue. These are described in more detail later in this volume under the title, "Other Fiscal Issues to Consider." Page references are provided for each issue.

?? **Tax Policy Initiatives – Non-Executive.**

Legislation is proposed as a result of studies performed during the recent interim by three committees: 1) the Revenue and Taxation Committee (RATC); 2) the Local Government Structure and Funding Committee; and 3) the District Court Funding and Structure Committee. The RATC recommends legislation to simplify the state income tax and the other two committees recommend several pieces of legislation that addresses, as the committee names imply, issues of structure and funding for these respective areas of government. (Page 84)

?? **Tobacco Settlement Funds.** As a settling party in law suits against tobacco companies, Montana began to receive this revenue in fiscal 2000, and will continue to receive it through 2017. In fiscal 2000, the \$34.8 million in revenue received was deposited to the general fund. For fiscal 2001, \$26.1 million is estimated. For the 2003 biennium, \$63.5 million is estimated. Passage of Constitutional Initiative 35 in November 2000 means that at least 40 percent of the settlement money must go into a permanent trust with the remainder going to the general fund. (Page 87)

?? **Sale of Electrical Generation/Distribution Assets.** The Montana Power divestiture is still in progress and is expected to be completed in the

first half of 2001. The announced total sales to date are \$1.788 billion, but related federal and state corporation capital gains tax liabilities have not been announced. This provides some uncertainty concerning potential revenues that will result from these sales. (Page 88)

?? **Mental Health Services: Interim Study.** The Legislative Finance Committee: 1) recommended six pieces of legislation; 2) requested that the Health and Human Services Joint Appropriations Subcommittee consider several issues related to public mental health services expenditures and budgets; and 3) requested that the Legislative Audit Committee undertake a performance audit of DPHHS internal management processes to ensure compliance with federal criteria in the administration of Medicaid funded programs. (Page 89)

?? **Earmarked Revenues/Statutory Appropriations: Interim Study.** Each biennium, the Legislative Finance Committee reviews dedicated revenue provisions and statutory appropriations. From the recent interim review, the committee recommends the de-earmarking of two revenue sources, the elimination of one statutory appropriation, and the addition of two statutory appropriations. (Page 92)

?? **Fund Balance Adequacy/Reserves.** Ensuring that there are sufficient revenues to fund state programs is the legislature's role. However, it is not enough to balance the budget as the expenditures and especially revenues can be affected by changes in the economy or natural events. The legislature's challenge is to ensure that there is an adequate fund balance reserve to protect the state spending plan from the unexpected. (Page 93)

?? HB 64: 15 Percent Budget Reduction Options.

The executive has submitted its 15 percent base budget reduction plans as part of the Executive Budget submission. These are intended to be used as a information resource by the appropriation subcommittees in their consideration of agency budgets. (Page 94)

?? Unified Computer Budget. The Executive Budget for the 2003 biennium is the first to include a "unified computer budget" as specified in HB 2 in the 1999 session. Actual fiscal 2000 information technology (IT) expenditures were \$77.9 million, or 10.1 percent of HB 2 operating expenditures. The total HB 2 request for information technology for the 2003 biennium is \$171.6 million. A select committee of the joint appropriations committee will review the unified computer budget, focusing on the IT rates and the most significant of the IT proposals. (Page 95)

?? Information Technology (IT) Governance. An interim study by the Legislative Finance Committee concluded that the legislature should create a Department of Information Technology that would focus on strategic planning, reviewing agency IT plans, developing IT policy, and evaluating IT budget requests. (Page 99)

?? Highway Special Revenue Account. The 2001 legislature is faced with a declining working capital balance in the highways state special revenue account. The account is projected to end fiscal 2002 with a negative working capital balance of \$2.4 million. Projections indicate that expenditures will exceed revenues by \$10.1 million in the 2003 biennium, with the imbalance continuing in future biennia. (Page 100)

?? Resource Indemnity Trust. During fiscal 2002, the Resource Indemnity Trust (RIT) is expected to exceed the \$100 million threshold "guaranteed by the state against loss or diversion." This will result in a redistribution of money that would otherwise have gone into the trust. In addition, of seven accounts that have historically received portions of Resource Indemnity and Ground Water Assessment Tax allocations or Resource Indemnity Trust interest earnings, four are projected to have negative balances by the end of the 2003 biennium. The legislature may wish to either consider the distributions of RIT funding streams to balance the revenue sources of the programs these funds are intended to support, or reduce appropriations from those funds. (Page 100)